Institute
and Faculty
of Actuaries

Member Options at Retirement

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The April 2015 flexibilities for DB schemes

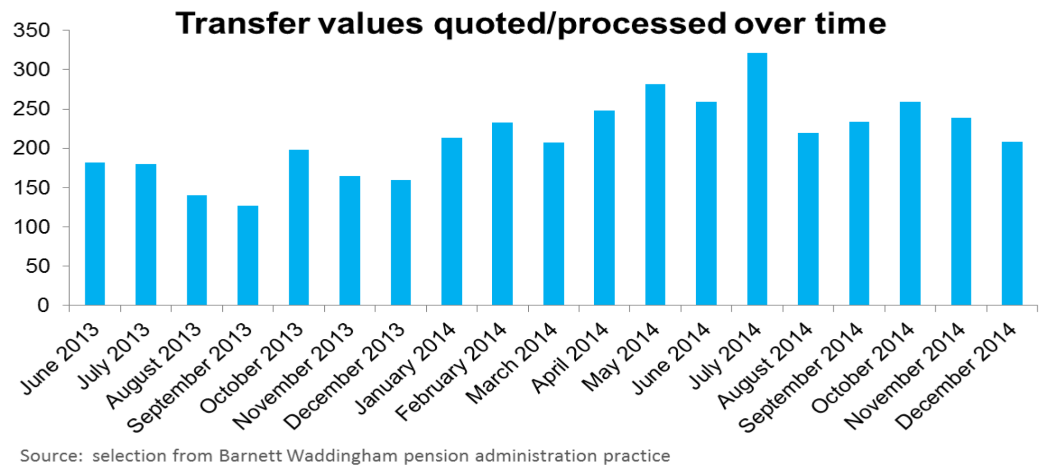
- Most flexibilities do not (yet) apply to DB schemes directly
- "Full flexibility" for DC funds
  - Access to DB funds via a transfer out
  - Requirement to take IFA advice for CETVs over £30k
- Right to take a partial transfer of DC/AVC funds
- UFPLS option for DC/AVC funds
- Restricted annual allowance regime for members in flexible drawdown
- Higher limits for trivial commutation and reduced age limit

The April 2015 flexibilities for DB schemes

- What we'll cover today:
  - Member behaviour
  - Scheme/employer behaviour
  - In particular thoughts regarding:
    - Transfer values
    - Commutation terms
    - Trivial commutation
- Most importantly, your views!

How might members act differently?

- Much more interest in transfers out from ages 55+
  - Treasury estimates 30% increase in take-up if they are set at 100% of best estimate



- Members will receive advice on most transfers
  - Costs will deter younger members
  - Advice may consider: marital status, state of health, family life expectancy
- Members will be in a better position to compare options:
  - e.g. 25% of a CETV quotation with their commutation option
- Trivial commutation as a default option

How might schemes/employers act differently?

- CETV quotes at retirement may be provided as standard
  - Offers flexibility and may reduce ultimate cost
  - Paternalism concerns reduced given advice regime?
  - But magnifies selection risk?
- Pension Increase Exchange may be offered at retirement for increasingly smaller schemes
  - Strikes a middle ground between flexibility of a DC transfer vs. the guarantees of drawing a DB pension
- Review factor bases
- Greater need for liquid assets?
- Schemes may seek to remind members eligible for trivial commutation
  - But may fall foul of the Code of Good Practice on Incentive Exercises

Background to different factors

Cash Equivalent Transfer Values

- Best estimate cost of providing benefits in the scheme (but can pay more)
- No allowance for options which reduce value of benefits
- Trustees must consider discretionary benefits
- Can reduce CETVs with insufficiency report

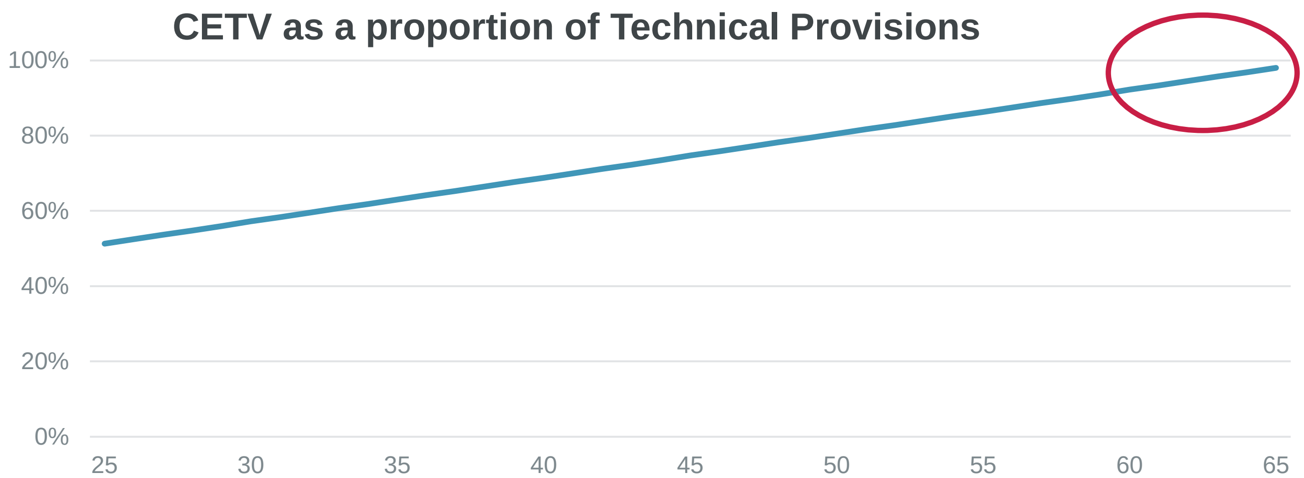
Trivial Commutation Factors

- No regulatory control
- Trust Deed and Rules may define the terms
- Typically ‘normal’ commutation rates with partner or a best estimate approach

“Normal” Commutation Factors

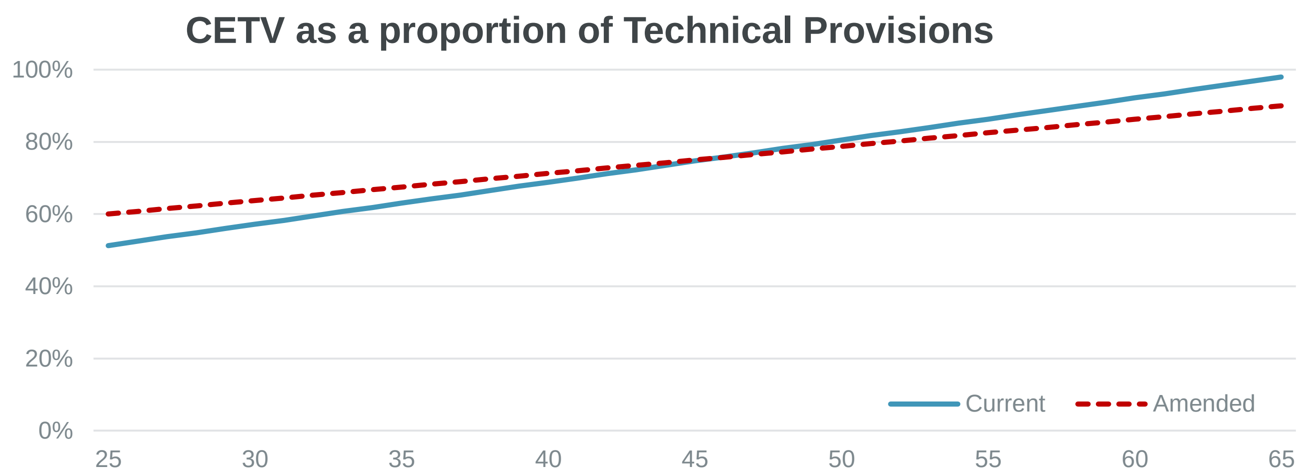
- No regulatory control
- Trust Deed and Rules may define the terms
- Often significantly below best estimate

Transfer values – Current approach



- Often set using a dual discount rate (before/after retirement)
  - Reflecting bond portfolio post-retirement
  - Margins vs best estimate returns may differ
- Advance allowance in TPs for commutation
- But very little (no?) margin in TPs for members transferring at retirement
- Concern for trustees if large numbers of transfers take place

Transfer values – Revised approach?



- Could rebalance CETVs from older to younger members
  - Technically by amending pre/post retirement discount rates or using a single discount rate under current conditions
  - More focus could be given to the 55+ age category in setting assumptions
- More underwriting for transfer values?
  - Spouse existence exercise can also improve reliability of funding and solvency bases
- Needs in depth discussion with trustees

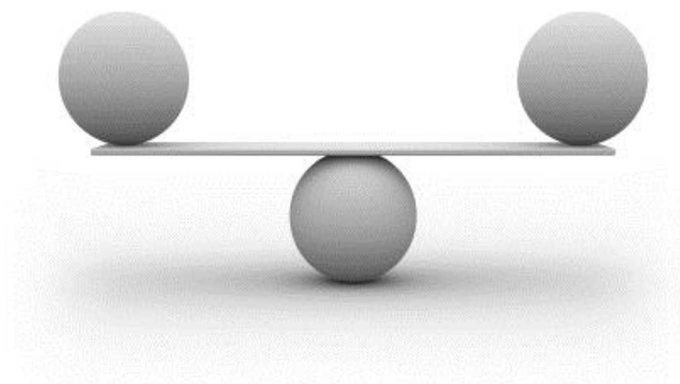
Transfer values – Selection risk

Might selection risk decrease after April 2015?

- Members may wish to transfer to access the flexible benefit regime
  - Transferring becomes a ‘normal option’
- End of compulsory annuitisation means members are no longer trying to ‘game’ scheme benefits compared to underwritten annuities

BUT

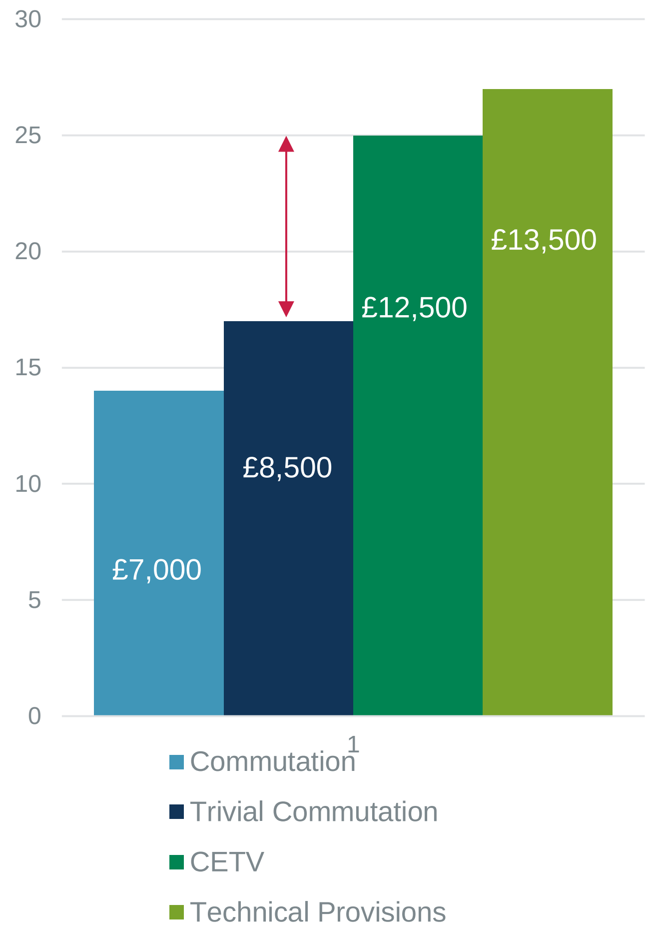
- Increased focus on advice may lead to a greater awareness by members of factors driving cross-subsidies (state of health, marital status, etc.)



Comparison of typical member options

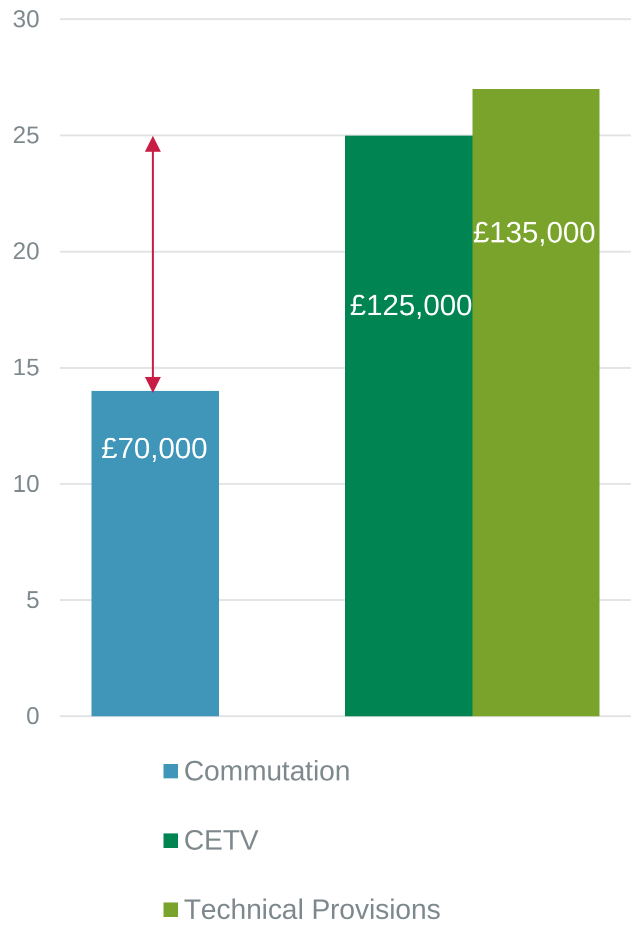
- The relationship between the headline commutation factor, the trivial commutation factor, the CETV and the technical provisions depends on lots of factors, including:
  - Single discount / dual discount rate
  - Preserved retirement age versus expected retirement age used in funding
  - Allowance for commutation in the funding
  - Level of commutation factors
- The following slides consider:
  - A trivial pension amount of £500 p.a.
  - A non trivial pension amount of £5,000 p.a.

Gap between trivial commutation and CETV



- Trivial commutation factors close to normal commutation factor but with allowance for partner pension
- Member takes trivial commutation directly from the scheme : £8,500
- Member takes CETV from the scheme and transfers to DC arrangement (without advice), then takes cash: £12,500
- Should trivial commutation factors be better aligned to CETV?

Low commutation factors



- Member might make comparison between:
  - Total value of benefits in the scheme

    = Pension x factor = £70,000, and
  - Available transfer value: £125,000
- More likely member might compare:
  - Benefits from scheme: maximum cash of £22,581 and remaining pension of £3,387 p.a., and
  - Taking a transfer value of £125,000 then:
    - Taking 25% as cash: £31,250
    - The remaining £93,750 as drawdown
- Effect of tax free cash calculations tends to hide the difference

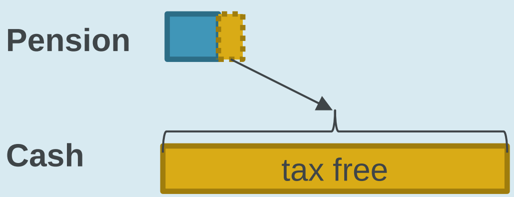
An additional view

Consider an example member

- Accrued pension = £5,000 p.a.
- Wants to take more cash than the scheme's maximum tax free lump sum

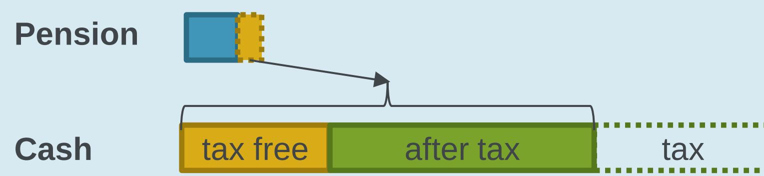
Current approach

- Exchange pension of £1,613 p.a. for cash
- Commutation factor = 14
- Cash = **£22,581** (all tax free)
- Residual pension = £3,387 p.a.



Alternative approach

- Transfer pension of £1,613 p.a. into DC
- CETV factor = 25
- Cash = £40,325 (25% tax free)
- Cash after tax = £40,325 x (25% + 75% x 0.6) = **£28,228** (assuming 40% tax rate)
- Residual pension = £3,387 p.a.



Member is better off under the alternative approach

- **Around 25% more** cash even after tax, if all basic rate tax then position even better (up to 52% more)
- **Same** residual pension (although spouse's is lower…)

Member communications at retirement

Option	Offer	Encourage	Enforce
Small lump sum at retirement (up to £10,000)	?	?	?
Trivial commutation at retirement (up to £30,000)	?	?	×
Transfer option at retirement	?	?	×
Partial transfer option at retirement	?	?	×

- May need rule changes
- "Offer" may mean signposting / an invitation to request a quote / an actual quote
- Level of 'encouragement' can vary

Trivial commutation exercises

- Offering (imposing) small lump sum and trivial commutation at retirement likely to be standard practice
- But exercises aimed at existing pensioners need careful consideration
- The Code of Good Practice for Incentive Exercises covers exercises where:
  - One objective is to reduce the risk or cost of the scheme, and
  - The invitation is not ordinarily open to members
- If the Code applies, then members must:
  - Be offered a balance deal, and
  - Receive guidance

Does the Code apply?

"One-off small / trivial pension exercises to existing pensioners and dependants would generally be expected to meet these two tests. Therefore, generally, we would expect the Code to apply to one-off exercises, but not to apply to "business as usual" activity (although the principles of the Code should be considered, in the normal way, as outlined in the Code). We would not expect the Code to apply where members are not given a choice (although the principles of the Code may be helpful)."

Incentive Exercises Monitoring Board

"For the purpose of considering whether the invitation or inducement is "ordinarily available", the content and context of the invitation or inducement should be interpreted more broadly than simply the financial terms of the offer. For example, an ordinarily available benefit option, that is being offered on ordinary terms, but which is being offered for the first time with an associated incentive (of any form), provision of financial advice, or ***potentially even a fundamental change to the communication of the option*** *is likely to satisfy this second leg, and may therefore be an Incentive Exercise if it also satisfies the first leg of the definition."*

Practitioner notes to the original Code (bold text added)

Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.